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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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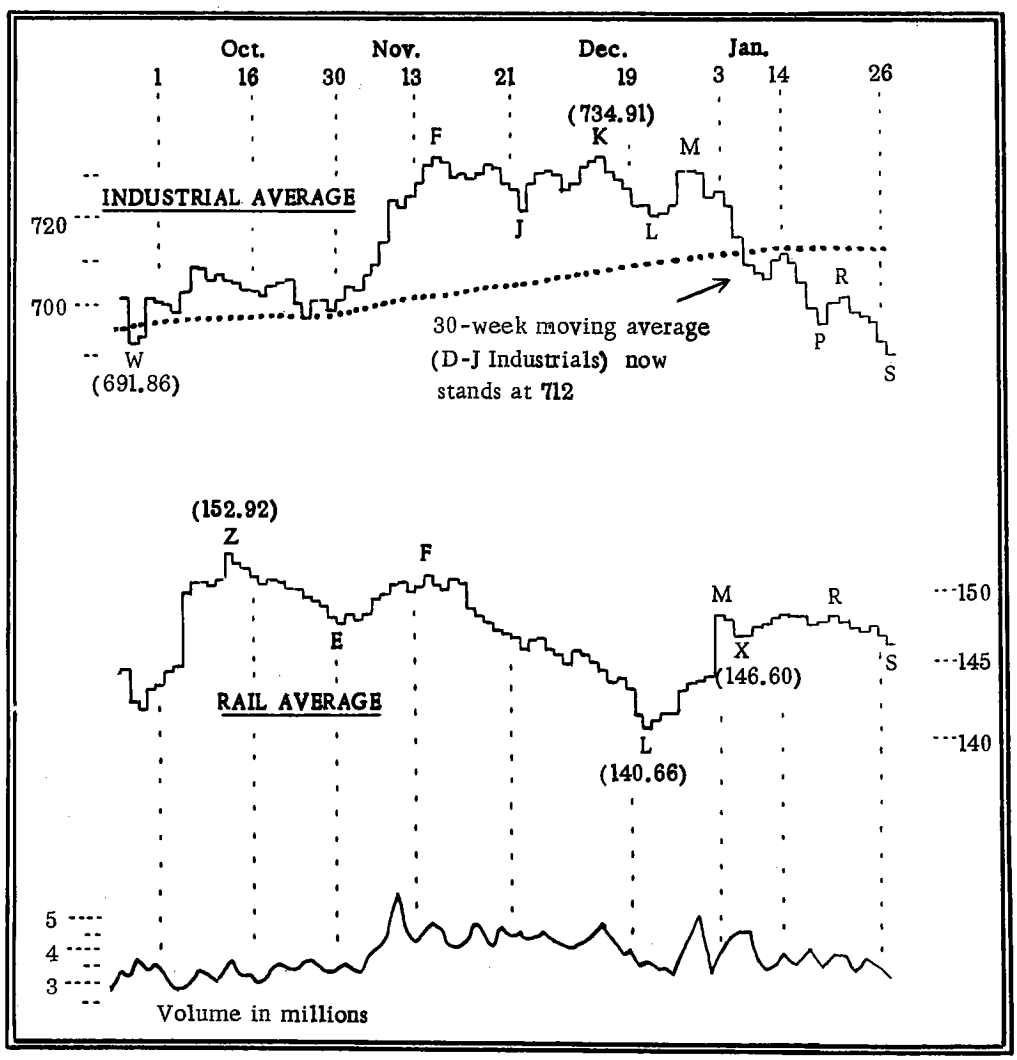
THE MARKET An article by the writer (in last week's Barron's) discussed the long series of diverging, non-confirming (and perflexing) movements which have been traced by the two Averages since March, 1961. The action of the Averages over the last week has done nothing in the way of unraveling the market puzzle. In fact, I have to go back to the 1946-49 period to recall another area which was so filled with confusing (and seemingly meaningless) movements.

All during January (to the present writing) Rails have held in an extremely narrow area, while Industrials retreated. Following the Industrial low at P, the Averages attempted to rally. Because Rails had been the stronger Average during January, the normal expectation would have been for the Rails to lead the market up from the P (January 18) lows. Instead of leading, however, Rails moved sluggishly sideways (which was rather strange action considering their recent strength).

It strikes me as almost comical that when the market is heading higher under the solo leadership of Industrials, Wall Street's analysts are quick to ignore or even disparage the Rails ("the carriers are finished as an industry"). But when Rails manage to hold or rally in the face of a sloppy market (as recently), the nation's scribes are prone to point to the carrier action as a sign of underlying strength in an otherwise unappetizing picture.

A student in a class which I teach here in San Diego asked me how I can consider the Rail Average as a valid index since it contains both Western rails which are "in good shape" and not subject to the tribulations of passenger traffic, and the Eastern rails which are, in a few cases, on the verge of bankruptcy and at the mercy of costly passenger traffic and falling carloading trends. My answer was that historically, the Rails (perhaps more than any other group) tend to move in unison. Moreover, (and not without irony) during the January period it was the Eastern rails (Central and Pennsy) which provided the real Rail strength, while good Western rails such as Southern Pacific and Southern Rail marked time or actually declined.



Letter 168 stated: "... a persistent refusal by Rails to violate one or both preceding levels (X-146.60, L-140.66) would mean that some doubts are still warranted regarding the bearishness of the situation." On the decline to P, Industrials retreated to within 33¢ of their September low at W (691.86), but Rails held above X (146.60). This refusal by Rails to violate their recent structure must be viewed as the "seed of hope" in the current market picture. A persistent refusal by

Rails to drop below X would suggest that a reversal (of at least minor proportions) was imminent.

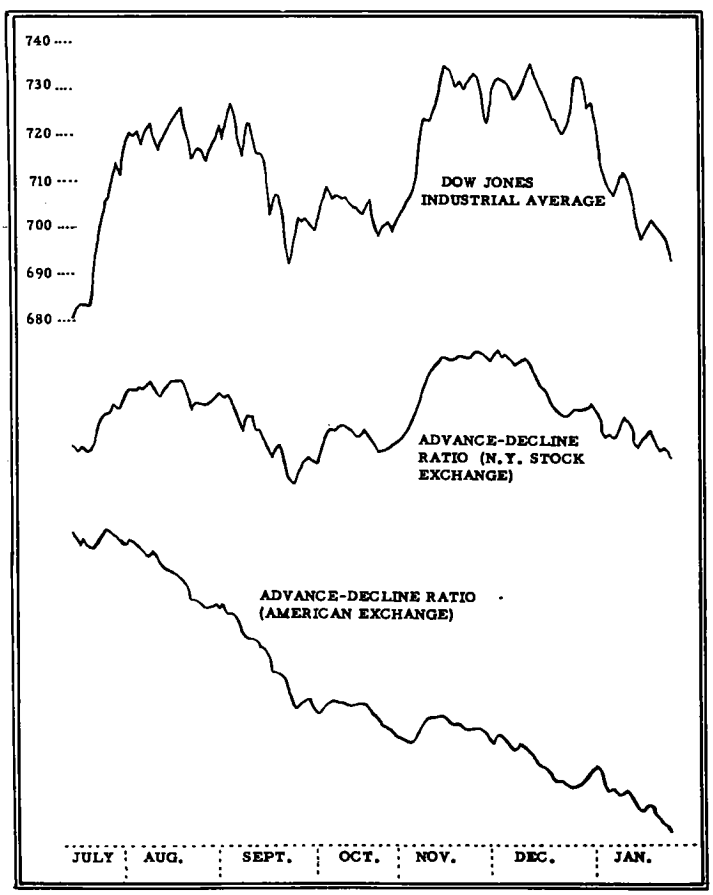
CONCLUSION The primary trend continues bullish. The secondary trend is obscure but very probably bearish. Industrials have descended to territory below their 30-week moving average but above their September low at W (691.86). Meanwhile, for nineteen trading days Rails have held within an extraordinarily narrow range of two points. The next important swing should be signalled by either (1) a rise of both Averages above the R points (Industrials - 701.98, Rails - 148.38) on Increasing volume, or (2) a decline by Industrials below their September low (W - 691.86) and Rails first below X (146.60) and then below L (140.66) on increasing volume.

On January 26 the five-day average of new lows expanded to 25, the largest five-day average since November 24 (see last Letter).

The Industrial Average has now lost 42 points or 25% of the gains registered since the October, 1960 lows. The declines of the last few days have begun to lack conviction,and volume (on the downside) is now dull. The odd-lot public has curtailed its buying, and the market seems to be groping for at least a temporary "bottom". The widely-advertised "selling climaxes" and subsequent "consolidations" have been noticeably missing from market declines since 1957. This writer suspects that we will not see either phenomenon prior to the next important rally.

A major (and bullish) non-confirmation would appear if Industrials violated their July low (679.30) while Rails held persistently above their own July low (133.49). Such an event would undoubtedly stir up a great deal of bearishness, and would (as far as I am concerned) provide a much more advantageous trading "buy-spot" than the current area.

TRENDS In early November (Letter 161) I reviewed the trends of the advance-decline ratios (A-D ratios) on both the New York and the American Exchanges. At that time it was shown that although the Industrial Average was acting well, the A-D ratio on the New York Exchange (representative of the advancing or declining tendencies of all the stocks on the "Big Board") was not following the lead of the "blue-chips". The opinion was expressed that the Industrial Average must lead the general market (A-D ratio) higher in typical bull market fashion, or the rest of the market would shortly lead the Industrial Average down. Obviously, the latter has occurred.



The hope was also voiced that following three extended downward swings on the American Exchange's A-D ratio, the worst might have already been seen. (The American Exchange is composed of a great many speculative or non-investment issues, and the action there is representative of the buying or selling proclivities of the general public). Unfortunately, events subsequent to November show that the American continues in the doldrums. The accompanying chart traces the almost unabated collapse of the A-D ratio on that Exchange. In fact, so severe and so persistent has been the decline on the American that it would seem that the "Junior Exchange" has been in the throes of something mid-way between a severe secondary reaction and an actual bear market. In all, this is hardly a comforting cog in the current rather shakey "big picture".

NOTES FROM "DREAMLAND" Life is different out here on the West Coast. The Southern Californian escapes the harsh reality of the Northern winter, and this seems to promote a feeling of euphoria and perpetual optimism. Californians plunge wildly into debt, buy cars and houses the way New York kids buy gum-drops, purchase land at prices that would make an Easterner gasp, and back a state governing body which is prone to float a 100-million-dollar bond issue at "the drop of a hat". Moreover, California possesses a strange attraction for "health bugs", members of the far left and right, exotic promotion schemes, and new ideas galore (some of the "new ideas" actually have merit). Five thousand (!) new settlers march into the "Golden State" every day, and by the end of 1962 they tell me I will be living in the most populous state in the union.

The New Yorker who moves out to "dreamland" (which is the name my wife and I have coined for California) can only blink, sink back into his sun-chair, and thumb sheepishly through the airmailed pages of his New York Times. Nevertheless, to this writer, the detachment of dreamland is conducive to meditation. And lately, I have been pondering over the many unprecedented phenomena which have accompanied the rise of the market over the last thirteen years. My thoughts are listed as follows:

(1) Since 1949 every major Industrial reaction has held above the halfway level of the preceding major advance (Dow's 50% Principle). Thus, we have been in an upsurge (without a major bear market correction) for over thirteen years, a performance unprecedented in stock market annals.

(2) From a low of 161.60 in June, 1949, the market has risen to a December, 1961 high of 734.91, an unequalled advance of 573 points to historic highs.

(3) The average yield on the D-J Industrial Average dropped to the 3% zone in September, 1958. Yields have remained in that area ever since, the longest period of low average yields in market history. The yield on the Industrial Average dropped below the average yield on Barron's 10 Highest Grade Bonds (an abnormal relationship, historically) in the last quarter of 1958; this inverse spread still stands, the longest such period in market history.

(4) Since 1949 there have been three joint penetrations of preceding secondary lows by the Averages (1953, 1957, 1960). In none of these instances did a major bear market ensue, and this again is "one for the books".

(5) Barron's (and Standard & Poor's) Low-Priced Stock Indexes recorded their peaks in April, 1959. The 1959 peaks have not since been bettered. In all other such instances, within a month to a year after the Low-Priced Indexes recorded peaks the market has collapsed. Again, an unprecedented "first" has occurred.

(6) The Rail Average touched a post-1929 peak of 181.23 in 1956. Five years have elapsed since then, and a continuing series of bull swings (Industrials are now 200 points above their 1956 highs) has not succeeded in taking the Rails above their 1956 high. No such relationship has ever been seen in the history of the Averages.

(7) The speculative "third phase" of the bull market began in early 1958. Following the inception of a third phase, all previous bull markets have continued to completion without interruption. If the bull market which began in 1949 is still intact, then we saw our first important interruption of a bull market third phase (1960).

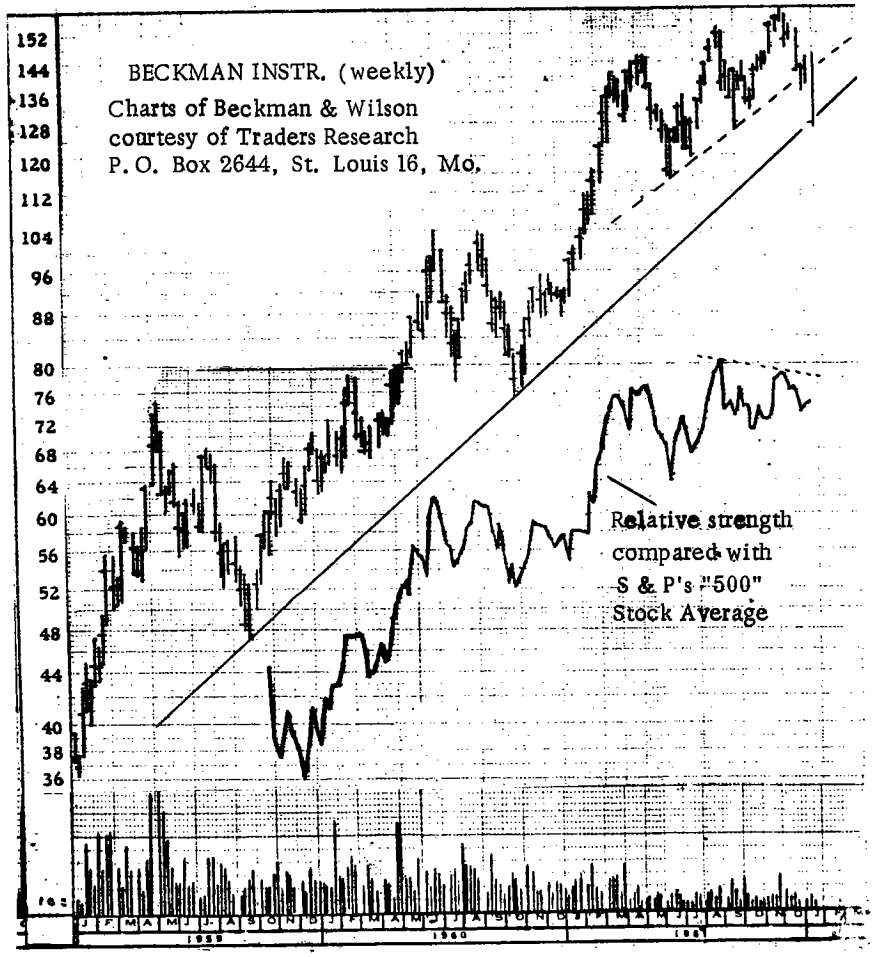
(8) As documented by Jim Hughes in Barron's (January 8, 1962): "... without exception, all major declines in the Industrial Average since 1919 have been preceded by a high in the investment accounts of the reporting member banks. From 1919 to 1959, the high points in banks' investment holdings have preceded highs in the breadth index. Now, in striking contrast, for the first time in the history of this relationship, the investment account has continued to advance beyond the high recorded by the breadth index in May, 1961".

So there we have it, a string of "firsts" which have no parellel in stock market history. How should this affect the thinking of the poor investor? My answer is that I do not believe it should affect the investor's basic attitude towards the market at all. Obviously, the surprises of the last thirteen years underline the danger of being dogmatic where the market is concerned. Yet history and the laws of physics show that for every action there is an equal reaction. Force gives way to counter-force, greed is followed by penitence, hunger leads to stockpiling and surfeit, and excess is followed by temperance. Therefore, it would not surprise me if the 1949-196? period were to lead the way to a period of great fiscal conservatism, disillusionment towards debt, frugality and a return to historically "normal" relationships. History shows the folly of accepting the unprecedented as a way of life. Sooner or later change will take over, and (in my opinion) the change will not lead (as is widely predicted) to the total Welfare State but towards conservatism.

LATE NOTES On Monday (January 29) Industrials closed below their September (W) low of 691.86, while Rails sank simultaneously beneath their first decline low at X (146.60). Bears on the market were probably disheartened by the 3.05 million shares of volume which accompanied the penetrations, the lowest volume in over three months. Bulls, on the other hand, could hardly have been encouraged by the joint penetration of two previous points. When the market is this difficult, I am a "sidelines observer". The current action reminds me of the trader who meets a fellow enthusiast. "Where's the market going, Joe?" asks the trader. "Going," groans his friend, "hell, I don't even know where it's been!"

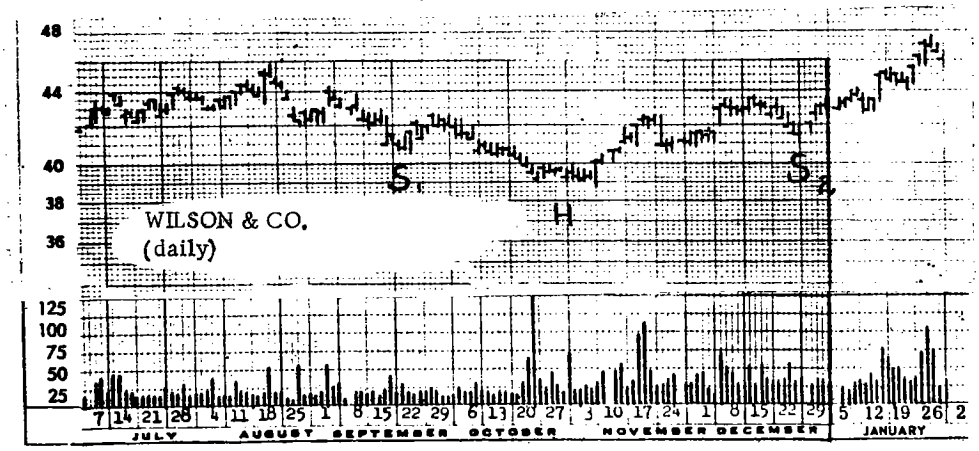
STOCKS Of 56 "key" stocks which are scrutinized at this office, 14 are now holding above their 10-week moving average This is the poorest showing since these studies were started.

The weekly chart of giant duPont shows what a reasonable "ride" via the 10-week moving average looks like. In January DD gave a clear "buy" as the stocks hurdled 193 on the moving average. DD rose to 254, then gave a "sell signal" as it broke under 240 (the moving average). I now list DD as bearish.



Beckman Instrument, one of the "glamor" stocks of the last few years, is in an interting position (and one representative of many of the glamor issues). Beckman broke an intermediate trendline (dotted line) and in so doing came down to exactly its long-term (solid line) trendline (which now stands at about 126). I attach a good deal of importance to long-term trendlines, and I consider a penetration of such a line ample reason for selling a stock. A decline to the low 120's would provide the "ample reason" on Beckman.

Of the stocks that continue to act bullishly, I list North American Aviation and Burroughs (both frequently mentioned) as outstanding leaders. Wilson & Co., a leading meatpacker is now added to the list. The daily chart shows an inverse "head-and-shoulders" accumulation pattern with expanding volume as the stock comes out of the right shoulder. North American, Burroughs and Wilson should be leaders on any advance from this area.



The following written Tuesday, January 30, 10:30 A.M. New York time: Industrials rallied over 5 points during the first hour this morning while Rails budged up a small fraction. In the absence of a "selling climax", it is probably that if we have seen the lows there will at least be a "pullback" with one or both Averages refusing to break to new lows (as was the case in October, 1960). Yesterday's lows at S were Industrials- 689.92, Rails- 146.27, and a return to that area on low volume with one or both Averages holding above the S points would provide a Dow "buy-spot".